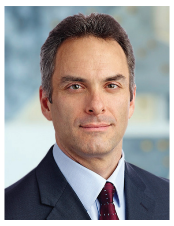
Practical advice for distressed M&A transactions

By Jayne E. Juvan and Christopher J. Hewitt

With Charlie Munger's passing late last year, we were reminded how he transformed Warren Buffett's investing philosophy from buying fair companies at wonderful prices to buying wonderful companies at fair prices.

One of the best ways to buy wonderful assets at fair, and maybe even wonderful, prices is to buy them from distressed sellers. There are many reasons sellers need to sell assets at distressed prices even though the assets themselves are wonderful — technical covenant defaults in debt documents, failure in succession planning, cash flow issues and entity-destroying litigation judgments, to name a few.



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The following are some ways sellers and buyers in distressed M&A can position themselves for a successful transaction.

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Advice to sellers

The No. 1 factor for sellers to be successful is to act before it's too late. Rarely are there no signs of impending distress before everything falls apart. Sellers need to be realistic and not emotional, accept the inevitable, and take action before needing to sell assets in a fire sale. Once the seller has lost suppliers, customers, employees and other stakeholders, the assets are much more likely to fetch a lower valuation than if the seller can sell a fully functioning, stand-alone business. The seller has a much greater ability to control the narrative on the purpose of the sale, even to the point that the buyer may not even know it's a distressed sale. There is also a greater probability of saving the rest of the enterprise.

Similarly, the seller should have an open dialogue with its lenders. Lenders don't like surprises, and the seller is likely to need the lender's assistance in any sales process — to obtain some form of forbearance or approval to sell the asset, to maintain liquidity during the sales process, to apply the sales proceeds other than to pay down or restructure debt. Lenders are more likely to work with distressed sellers if there is open and honest dialogue about any financial problems.

If possible, the seller should try not to sell assets as is-where is. While no-recourse deals have been in vogue recently, the pendulum is swinging back toward at least some limited recourse against sellers. Especially if the transaction is structured as an asset deal where the buyer is cherry-picking the assumed liabilities, there is no reason not to stand behind the representations in the purchase agreement. Just make them true!

Lastly, don't overcomplicate the sales pitch. Focus on why the assets are wonderful and, if known, how they are critical to the buyer's business. In many cases, the most logical buyers are the seller's competitors. The seller should leverage its knowledge about the buyer and create a simple narrative to confirm what the buyer may already suspect about the worthiness of the assets.

Advice to buyers

First and foremost, pay a fair price. The worst-case scenario for a buyer that exerts its leverage to get a sweetheart deal is the seller goes bankrupt. The trustee for the estate may allege the assets were transferred for less than adequate consideration. If successful, the buyer will either be required to return the assets or pay the difference between the purchase price and their fair value.

As a corollary to sellers not seeking non-recourse deals, buyers shouldn't expect perfect information about the seller or the assets. If possible, buyers should structure the deal as an asset purchase, limit the assumed liabilities, protect against successor liability issues, ensure the seller is solvent, and complete reasonable due diligence to feel confident the assets are what the buyer thinks they are. Then, risk-adjust the purchase price on real, not perceived risks, while ensuring the purchase price is adequate consideration on that risk-adjusted basis.

The buyer could seek a 363 sale in bankruptcy to protect against unknown liabilities and a possible fraudulent conveyance claim. Sellers may not be willing to entertain a 363 sale, given the higher transaction costs associated with the bankruptcy process. Also, the buyer could lose control of the process as the stalking horse bidder, end up burning a lot of time and money, and walk away with nothing.

Conclusion

Distressed sales are a perfect opportunity to reallocate wonderful assets from distressed companies to those that can more effectively use them. Done properly, sellers can right-size their companies and possibly save them from bankruptcy, and buyers can obtain quality assets at bargain but fair prices.

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